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Should Investors Go International?

by Ed Hynes, CFA
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Should investors buy international stocks? Most financial commentators say yes and believe investors should have significant overseas exposure. I disagree.

When surveying our world, I am confident many countries will grow faster than the US and see bigger increases in their standards of living. The problem is that it is very difficult to turn either of these observations into real investment opportunities.

To get a better handle on the issue, it is helpful to divide the world's stock markets into two groups: developed and emerging. There are about 25 developed markets including all of Western Europe, Australia, Japan and Canada. The other countries are referred to as emerging markets and make up most of the world. From a population perspective the largest are China and India.

Let's start by looking at the emerging markets and use China as an example. No one doubts China's economy is growing and will one day be among the largest in the world. Prospective investors must ask if they can find a way to invest in its growth with a reasonable expectation of making money.

If I could buy a Chinese stock or index which reflected the whole economy, investing might be a reasonable proposition. But no such product is available and the only investments most of us can make are in the companies that are publicly traded. In a country like the US, most of the country's economic activity is carried out by publicly listed companies and this is not a problem. But this is almost never true in emerging markets where stock markets do not accurately or fully reflect their country's economy.

Another problem with emerging markets is the level and reliability of financial information. This can be a big issue anywhere, (remember WorldCom and Enron) but is sometimes magnified overseas where accounting rules and oversight are still evolving.

We also need to take into account that emerging markets tend to be very volatile and this can only be partially controlled by long-term investing. The bottom line is that individual investors should probably avoid emerging markets.

How about investing in developed markets? Supporters give two primary reasons for putting money into these markets. First, Americans should invest internationally to

benefit from the growth of other economies; and second, by having some investments overseas, your portfolio is less risky due to its diversification.

Do you think other developed economics will grow faster than ours? Will the German, British, French and Japanese markets, as a group, do better than ours over the next 20 years? I may be arrogant, but I see no reason to make that bet. Of course, there are many world-class companies outside the US, such as Toyota and Nestle, but that doesn't mean their home stock markets are attractive.

Coming at this from a different angle, US investors already have substantial international exposure as about 40% of the S&P 500 revenues come from outside the US. Globalization is happening and US companies and their shareholders already have significant exposure to the rest of the world.

The diversification benefit of holding an international portfolio is probably an illusion. Theoretically, the lack of correlation between the US and these markets protects investors. But such relationships are unstable and we know these correlations rise when the US market falls.

The markets' reactions to 9/11 are instructive. This was clearly a US event, but in the following days and weeks, the developed markets fell more than our market. When the US market hits the skids, so do the rest of the markets.

A final reason for being skeptical about international investing is fluctuating foreign exchange rates. If you own a foreign security, your return will be a combination of how the stock performed at home and how its currency performed relative to the dollar. For instance, the dollar had been getting weaker for the past 5 years until reversing somewhat this year, and its movements can make an international investor a hero or a dog regardless of how a particular stock performs at home.

In summary, I believe the benefits of investing overseas are overplayed. I reach this conclusion not because I refute the trend toward globalization, but precisely because I appreciate our interdependence. This in turn makes investments in international developed markets unnecessary.

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